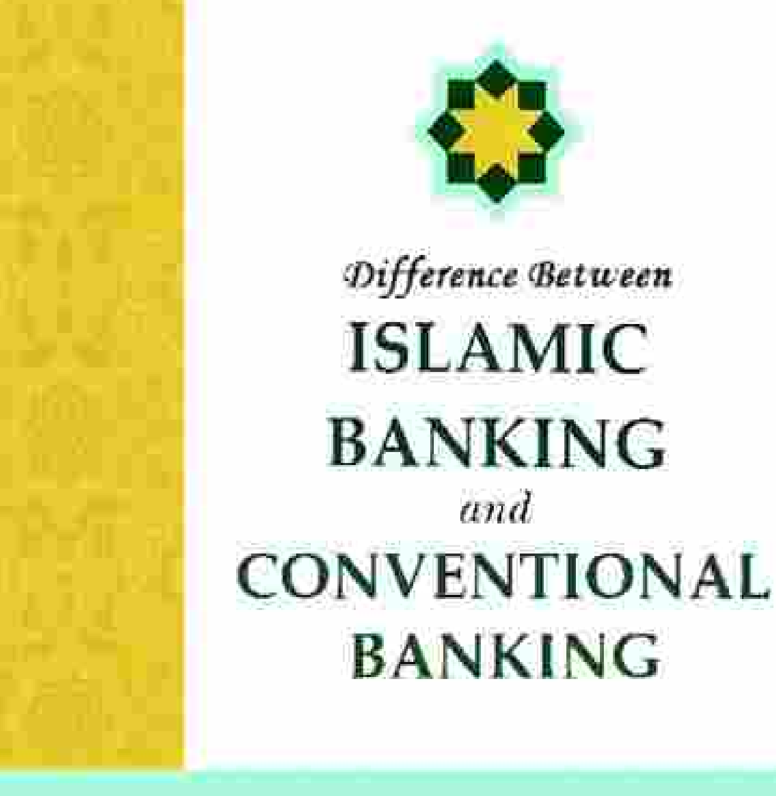


*Difference Between*

# ISLAMIC BANKING *and* CONVENTIONAL BANKING


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# Difference between Islamic And Conventional Banking

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الحمداللّٰه رب العٰلمين۔ والصوة والسلام على سيد

الانبياء والمرسلين وعلى آله واصحابه اجمعين۔

اما بعد:

Times have changed and are continuing to change at an exceptionally fast pace. No one can deny that advancements in the fields of science and technology have not impacted his or her life. However these revolutionary changes are taking place in every walk of life. The field of economics is no exception. It has witnessed tremendous development in a short span of time making it highly advanced and intricate. Hedge funds, derivatives, usage of different indices and bench marks, similarly the whole modern Banking systems is the result of advancement in the field of Economics.

It is heartening to learn that Islamic banking is growing not only in our country but throughout the world at a very healthy pace. As a result, new Islamic banks are emerging on the horizon and many conventional banks are also establishing their Islamic banking units. This change not only fortifies the fact that Islam is a religion which has the full potential to provide solutions for the latest issues and problems even fourteen centuries after its advent, but it also shows a new resilience on part of the Muslims to practice Islam in all spheres of their lives specially in issues relating to the financial matters.

## Current Islamic banking is not ideal

A common question which arises about current Islamic Banking system is that this system has failed to deliver those benefits to the society which should be a part and parcel of an Islamic economic system. Hence the Shariah credibility of the whole system is questionable. The observation is correct to great extent; however it still does not make the current Islamic banking system impermissible.

It is a reality which no one belonging to the circle of Shariah Scholars deny that the benefits of Islamic economic system will not become truly obvious until and unless the whole package of Islamic injections pertaining to the financial welfare of the society are not properly implemented. This means that trade and business should be mainly conducted on the basis of Musharakah and Mudarabah and simultaneously the other tools which Islam has provided for distribution of wealth like Zakat, Ushr, Charity and Inheritance should be properly applied. If this is done there is no reason that we will not observe a significant positive change. However, this does not mean that use of any other mode of trade and business except from Mudarabah and Musharakah is totally disallowed by Shariah. If trading is conducted in any form which compiles to the principles of Shariah then there is no reason to call it impermissible. Hence if Islamic banks are using Murabaha, Ijarah, and Diminishing Musharakah etc, as modes of finance within the framework and principles of Shariah then it is not correct to state that this is Haram and impermissible merely due to the fact that these modes are not based on Mudarabah and Musharakah. However Islamic banks should put their sincere efforts in promoting Musharakh and Mudarabah as modes of finance because these are those ideal modes of finance which create a more balanced system for distribution of wealth.

## It's all the same

Some people argue that Murabaha and Ijarah is not being used in Islamic banks according to the principles of Shariah, in fact interest based transactions have been disguised in Islamic names and merely changing the name does not change Shariah ruling. This means that current Islamic banking is actually same as conventional Banking with only the changes of name.

The fact is that they have come up to this conclusion by merely looking at the end result of a financial transaction whether it was executed through conventional mode of financing or an Islamic mode of financing. They observe that if a person gets a loan of Rs.100,000 from a conventional bank and pays off Rs. 110,000 after a year, the same may hold true for a person who gets Rs. 100,000 Murabaha or Ijarah financing from an Islamic Bank and returns Rs. 110,000 after a year. Since in both cases both end up giving same amount of money there is no difference between the two. However, this argument is not correct according to Shariah. Shariah Scholars are unanimous on the fact that if the end result of two transactions is same it does not necessarily mean that Shariah ruling about them is also same. The basic reason behind this is that the ruling of Shariah depends on the essence of the transaction and not on the end result. This could be understood through a simple example that a person prepares two dishes by using exactly the same type of recipe and cooking technique which give both the dishes same look and taste. The only difference is that meat taken for one dish was from the goat on which Allah's name was taken while slaughtering it and the meat for second dish was taken from the goat on which Allah's name was purposely not taken. No Muslim who knows this will term the second dish Halal or vice versa the first dish Haram due the fact that they look and taste exactly

similar. Same could be said about two different couples living together, both fulfilling their social responsibilities towards their respective partners. The only difference between the two is that the first couple is living together after a Nikkah was solemnized between the two, while the second couple is living outside wedlock. Shariah deems that living together of the first couple as not only permissible but a basis of blessing from Allah. While living together of the second couple is not only impermissible in the eyes of Shariah but is also the basis of attracting wrath of Allah. In the above example the worldly and social benefits attained by both the couples are totally same however the Shariah ruling about them is totally opposite. The reason for this is obvious that although the end result is the same but the essence on which each relationship is based is different.

In a similar fashion a person getting an interest based loan from a conventional bank and a person purchasing an asset through Murabaha may look same with respect to the financial end result but both the transactions differ in their essence and consequently in their Shariah ruling. Therefore, it is unjustifiable to call both the transaction as same merely due to the fact that their financial end result is same.

The Kuffars of Makkah made the same mistakes while not being able to differentiate between a Riba transaction and a sale transaction as the Holy Quran quotes them, they said إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا "Sale is like Riba" which means that just as in a Riba transaction, excess is received on the actual loan investment, in a sale transaction a seller also receives an excess on his sale investment which means that keeping in view the end result both look similar then why one is Halal and other is Haram?

The answer to their argument has been given in a majestic manner “ وَأَحَلَّ اللهُ الْبَيْعَ وَ حَرَّمَ الرِّبَا " Allah has permitted sale and forbidden Riba" stressing the fact that Allah's commands are to be followed in

every instance whether a person could understand it's logic or not. It becomes quite obvious that the end result of the two transactions could not be made the criteria here as it is apparently the same.

However both the transactions differ in essence and this is actually the basis of one transaction made permissible and the other impermissible.

## Islamic banks should not earn profit

Some people are of the view that Islamic banks should be nonprofit organizations and should do banking on the basis of Qarz-e-hasan and if Islamic banks will also earn profit just like conventional banks earns profit, then what's the difference between the two.

It seems that according to this view if Islamic banking is done on the basis of Qarz-e-hasan then only it is permissible. There is no doubt that the idea is quite noble and could be achieved by forming special trusts and nonprofit institutions for this purpose. However, it is unrealistic to expect banks to adopt this structure. Banks are formed with a clear profit motive just like any other business and they are not charitable organizations. Moreover Shariah allows earning profit through permissible means whether through business, trade, service or any other permissible way. Therefore, if Islamic banks are earning profit through permissible modes of finance then it should be acceptable and merely due to this similarity can Islamic banking be termed impermissible?

Supposedly if this rule is applied then all permissible businesses should be Haram as they resemble impermissible businesses in earning profit.

## Why is there an outward resemblance

Some people say, “The profit rate given by Islamic banks on deposits is quite similar to the interest rate given by conventional banks to their depositors. This resemblance makes it clear that both systems are the same”

These people are ignorant of the fact that the Shariah has not based the permissibility or impermissibility of a transaction on the amount of profit earned from it. The determination of the rate of profit has been left to be mutually decided by the parties of a transaction. Therefore, if an Islamic bank gives its depositor an amount of profit that resembles the rate of interest that conventional banks give to their depositor, why should it be a point of objection?

Let us go a little deeper into the matter and try to understand why this resemblance is found. Islamic banks are currently using Murabaha, Ijarah, Diminishing Musharakah, Salam and lstisna’ as modes of financing. In all these modes of financing , the bank essentially purchases an item and sells it or leases it out to the client on a fixed profit.

Presently, Islamic banking is operating as a parallel system in addition to the conventional banking system and the competition between the two is at its peak. Generally, Islamic banks try to make a similar amount of profit on their Ijarah and Murabaha transactions as conventional banks do on their interest based loans to make it easy for customers to trade with them and encourage them towards Islamic banking. If Islamic banks turn their sight away from the prevalent market rates and charge a higher effective rate than the criticism would be that Islamic banks are too expensive and impractical. On the other hand, if they provide their service at a very cheap rate, the depositors

would complain of receiving very small profits as compared to the interest that depositors gain from conventional banks.

Hence, in order to safeguard themselves from these questions, to challenge the existing parallel conventional system and to encourage people to incline towards Islamic banking, Islamic banks try to acquire a similar rate of return on their profit based financing. And it follows from this that the amount of profit that an Islamic bank makes and distributes to their depositor will also be similar to the interest that a conventional bank gives to its depositors. This is the background towards this outer resemblance, but as mentioned above, if the method adopted is correct then merely because of this resemblance, the system cannot be rendered impermissible.

## An Example of a Conventional Bank

Now let us analyze the impermissible aspects of a conventional bank so that it is easy for us to understand the difference between a conventional and an Islamic bank.

As far as the financing activities of conventional banks are concerned, they are primarily interest based. Conventional banks essentially provide money to their clients on a condition that they would return a higher amount to the bank. Their leasing product, however, requires more explanation which will be clarified in the section on leasing.

It is clear that interest based transactions are impermissible and totally prohibited. Hence, the financial transactions of conventional interest based banks are not permissible according to the Shariah. However, transactions/services such as remittances, charges of permissible services etc. are not against the principles of the Shariah.

Hence, providing such services and charging an appropriate fee for them may be allowed.

In other words, a conventional interest based bank is like a supermarket in which both Halal and Haram commodities are on sale. It has pork and wine being sold at one section as well as fruits and vegetables being sold at another section.

In such a situation, it is clear that one should never conclude that all the transactions of the super market are contrary to the Shariah. Rather, in such a situation a fair and just view would be that some of the transactions of this super market are impermissible while others are permissible according to the Shariah.

The argument presented above makes it clear that a conventional bank is not entirely unislamic. People who consider conventional banks as nests of completely impermissible transactions and state that they have no place at all in the teaching of Shariah are infact mistaken.

Now that we know that some of the transactions of conventional banks are permissible, it is not necessary for us to search for Shariah complaint alternatives for such transactions. We only need to find practical Shariah compliant solutions for those transactions which are contrary to the principles of the Shariah.

## The Two Basic Sides of Banking Transactions

The financial transactions of a bank are generally divided in two sides;

1. The Asset side – This side of a bank's transactions refers to the financing facilities that the banks provide to their clients. For

instance, a conventional bank provides financing to its clients by giving them interest based loans where as an Islamic bank provides financing to its client based on profit based financing such as Murabaha, Ijarah, Salam, Istisna etc.

2. The Liability side – This side of a bank's transactions refers to the deposit and investment facilities that the bank provides to its clients. A conventional bank accepts deposits from its client and forwards them on interest to other clients who require financing. The interest that accrues on such a transaction is distributed amongst the depositors and the bank. On the other hand, an Islamic bank receives deposits on the basis of Musharakah or Mudharabah and invest these fund in a Shariah compliant manner. The profit that is earned on such a transaction is thereafter shared amongst the bank and the depositors based on a pre agreed profit sharing ratio. (this will be explained in more detail later on InshaAllah)

## Comparison between conventional and Islamic banking transactions on the asset side

A conventional bank's transactions on the asset side include financing on interest. It is clear that the underline transaction of all such financing, is an interest based loan no matter what purpose the client may have taken this facility for. An Islamic bank, on the other hand, provides financing facilities based on different transactions depending on the requirements of its clients. The following are the three common types of transactions used to provide financing facilities:

1. **Murabaha**
2. **Ijarah**
3. **Diminishing Musharakah**

In addition to the above, sometimes Salam and Istisna are also used to provide financing facilities.

Come; let us now discuss the transactions of Islamic banks in some detail.

# Murabaha

Murabaha is a type of sale in which the seller informs the buyer about the cost at which he would acquire the goods and the amount of profit that he would sell the goods at to the buyer.

In other words, together with all the other conditions of a valid sale, the seller is obliged to fulfill one more condition which is to disclose his cost and the amount of profit he would make on the transaction.

Murabaha transactions, that are concluded in Islamic banks comprise of the following stages.

**1. Signing a Facility Agreement**

In the first stage, the client and the bank arrive at a mutual understanding of the transactions that would commence and sign a general agreement or facility agreement. The limit of the amount at which the client will purchase goods from the bank, the profit that the bank will make on these goods, the method of payment of these goods etc. are amongst those aspects that are agreed upon in this agreement. (It should be noted that this is not the Murabaha transaction. It is merely a memorandum of understanding or a general framework for the transaction that would follow.)

**2. Purchasing the desired goods**

Thereafter the bank purchases the goods from the market that it would later sell to the customer.

At this point, the Islamic bank either purchases the desired goods

form the market itself or appoints an agent other than the client to purchase these goods. However, in case of necessity the client himself may be appointed as an agent of the bank to purchase the goods from the market on behalf of the bank. (See: Shariah Standard by AAOIFI)

From this we understand that it is not necessary for the client to be appointed as the bank's agent and neither does the Islamic bank stipulates that it would only sell goods to the client if the client agrees to become its agent. In fact, if circumstances do not allow the bank or an agent of the bank other then client to purchase the goods, only then can the Islamic bank appoint its client as an agent to purchase the goods. However, currently Islamic banks generally appoint their clients as their agents to purchase goods on their behalf. The client also prefers to purchase the goods themselves as the bank or a third party client may not be aware of their exact requirements. Infact, there is a strong possibility that the required goods purchased by the bank or the third party client may not fulfill the requirements of the client and the client may reject the goods. In such a situation, if the supplier refuses to take the goods back, the Islamic bank would suffer a heavy monetary loss. Therefore, with the mutual agreement of both parties, the client can be appointed as an agent to purchase the goods on behalf of the bank.

**3. Taking possession of the purchased goods and informing the Islamic bank**

If the client himself is appointed as the agent of the bank to purchase on its behalf then, he is supposed to take possession of the goods after purchasing the required goods and inform the bank accordingly. According to the Shariah, the possession taken by an agent is considered as possession taken by the principal. Hence, these goods are now in possession of the principal, which is the bank and

all the rules pertaining to possession would take effect immediately. At this point if these goods are destroyed without any negligence on part of the client, then the bank would have to bear this loss. The client can not be held responsible for such a loss. Similarly if the goods are being imported from a foreign country, the risk of the goods being destroyed lies with the Islamic bank until the goods reach the country of import, and are sold to the client. In case of destruction the bank would have to bear the loss.

### 4. Execution of Murabaha

After purchasing the required goods as a bank's agent the client offers to purchase these goods from the bank at a certain price which clearly states the cost of the bank and its profit. The client agrees to pay for the goods either immediately or according to a particular schedule. When the bank accepts this offer, the Murabaha transaction is concluded and the client becomes responsible to pay the amount agreed upon to the bank. The bank acquires some collateral from the client as a guarantee for the payment of this amount.

This is the gist of the transaction that has been named Murabaha in Islamic banks. The different stages of Murabaha mentioned above are not against the Shariah or they are impermissible. However, it's the responsibility of the Islamic banks to execute Murabaha with the above mentioned details & conditions.

## The Difference between Murabaha and an Interest Based Loan.

The above explanation clarifies the fact that there is a world of difference between the Murabaha transaction and the conventional interest based loan.

A conventional bank advances cash on the basis of a loan against which it earns an interest. As these funds are advanced on the basis of a loan the bank does not bear any risk of loss on these funds. On the other hand, an Islamic bank first purchases an item and by taking its possession, assumes the risk of that item. Thereafter, the bank sells it at a specified profit. This transaction is same as that of a shopkeeper who purchases goods and sells them in his shop at a specific mark-up. The only difference is that a normal shopkeeper does not generally discloses the cost and profit to his customer (this sale is called Mussawamah), whereas an Islamic bank discloses its cost and mark-up in Murabaha.

According to a verse of the Holy Quran, sale is permissible whereas interest is prohibited:

وَأحلَّ اللّٰه الْبَيْعُ وَ حَرَّمَ الرِّبَا (البقرة)

Translation: "and Allah has permitted sale and prohibited interest."

As Murabaha is also a type of sale and the Holy Quran has permitted sale transactions (buying and selling), Murabaha transactions are also permitted, provided that the required conditions are adhered to.

The logical reasoning for the permissibility of Murabaha is that the Islamic bank assumes the risk of the subject matter of the sale and it is a law of the Shariah that the one who assumes the risk of an item is eligible to earn a profit from that item. الغرم بالغرم

It should be kept in mind that "risk" refers to the risk associated with the subject matter of the sale and not the risk of default by a client. The risk of default by the client is found in every transaction

but no expert of Shariah has permitted any transaction based on this risk to date. However if by assuming a risk, the risk of default of the client is considered to be meant, then there would be no transaction in the world that would be impermissible whereas there are many transactions that are impermissible in the light of the clear rulings of the Quran and Hadith.

# Ijarah

Ijarah in the terminology of Shariah is called to hire a specific thing or a person for a permissible purpose against specific remuneration.

Ijarah is basically of two types.

**1. Ijarah of an asset**

To rent out something which is called leasing in English and in the terminology of Fiqh it is called "(اجارۃالاعیان)"

**2. Ijarah of a person**

To hire ones services for a specific remuneration, it is usually referred in English as employment, while in the terminology of Fiqh it is called as "(اجارۃالاشخاص)"

Ijarah of an asset (اجارۃالاعیان) or lease is further of two types:

1. Financial lease (اجارۃتمویلیہ)
2. Operating lease (اجارۃتشغیلیہ)

**Operating lease**

Operating lease is the Ijarah done commonly in which a person or an institution leases its specific asset for a specific period against a specific rent, and after the expiry of the period the asset is returned back to the owner. For example renting out a house or a shop or any item of daily usage like tent, speaker system etc. This type of Ijarah is in practice since long.

**Financial lease**

The type of Ijarah which is used in the banks is the finance lease. This type of lease was adopted as a form of capital investment and Ijarah was used as a tool of financing. The asset is leased out for a specific period like 3-5 years in which the lessor receives the principal with the profit of the asset in the shape of rent and after the lease period the ownership is transferred to the client or lessee.

**Defects in Conventional lease**

The finance lease in practice in the conventional banks has the following the Shariah defects.

1) The agreement comprises of sale and lease contracts since the installments paid by the client is initially considered as rent, while at the end of the lease period it is supposed to be the price of the asset and the ownership is automatically transferred from the institution to client without any further contract.

If such transaction is analyzed in the light of Shariah it will be considered that the client asks the institution in such a manner that "I will take this car on rent with the condition that at the end of lease period I will be the owner of the car against the rental paid.

"Islamic jurisprudence will consider this transaction as صفقتان فی صفقہ or two contracts tied in a contract which is not permissible. Such a transaction is clearly prohibited in the Hadith (see 398/, مسند احمد Nasai # 4629, Tabrani al Awsat # 1633)

2) All the liabilities of the leased asset are borne by the lessee, where as the Shariah only imposes the liabilities on lessee which are regarding

to the usage of the asset. For example in a car the lessee's liability is to make service, change the oil, etc, while the liabilities regarding the ownership are the responsibility of the lessor, like paying ownership taxes and the maintenance of asset if it is defected/destroyed without the negligence of the lessee.

3) Rentals are charged from the lessee even before the asset is delivered to the lessee while Shariah does not allow to charge any rental unless the asset in working condition is handed over to the lessee.

**How are these defects being eliminated in Islamic banks?**

These defects have been eliminated in the Ijarah product, designed for the Islamic banks in the following manner.

1) During the lease period only rental contract is signed between the client and the bank. Hence the asset remains in the ownership of the bank from beginning to the end of Ijarah. At the end of Ijarah after handing over the asset back to the owner, the client is given an option that he might purchase the car through a separate sale contract.

2) It is clearly mentioned in the Ijarah contract that the liabilities regarding "Minor Maintenance" will be borne by the lessee while the ownership expenses like tax, takaful, defects in case of accident will be borne by the bank. This is what Shariah requires.

3) The bank does not charge any rent unless the asset is handed over to lessee.

A little detail is needed to understand the third point.

Whenever a client comes to the bank for the lease of a car or

machinery usually the Ijarah agreement is not executed on that day. Rather the bank books the car, and after some time when the car is ready it is handed over to the client and Ijarah comes into existence.

The rentals of the leased asset in Ijarah usually starts when the asset is handed over to the client, and since the asset to be delivered usually takes some time, occasionally clients demand to pay some amount from the beginning for his convenience.

Islamic Banks are instructed not to take rentals unless the leased asset is handed over to the client, but if the client demands and wants to give some amount from the beginning then the bank may take it as on account basis. These amounts will not be rentals nor can be treated as income rather it will be on trust basis, which will result if Ijarah is not executed between the bank and the client, the bank will return the amount to the client, while the conventional banks treat this amount as their income from the beginning.

The above detail clears the difference between the procedure of Islamic banks and the conventional banks, and also clears the argument made by some people that there is no difference between them, as some Islamic banks also take rentals from the very first day.

## Difference between Ijarah and Conventional Lease.

A common argument is also given that Islamic banks in Ijarah say that they bear the risk of the leased asset, but like conventional banks, Islamic banks also insure their leased asset. Therefore, whatever loss occurs, it will be the loss of insurance company.

The answer to this argument is that first of all, Islamic banks do not insure their asset from the conventional insurance companies,

rather they are bound to have their agreements from Islamic insurance or Takaful. Conventional insurance is not permissible since it consist of Interest, Gambling & Uncertainty, while in Islamic Takaful these impermissible elements have been removed.

Secondly although the conventional bank insures its asset, but in case of loss if the claim amount is insufficient, the bank does not bear the loss and recovers it from the lessee. On the other hand in case of loss if the amount of claim from the takaful company is insufficient, the Islamic bank bears this loss by itself and is not recovered from the client rather it hands over the security deposit back to the client.

This difference clears the fact that the conventional bank does not consider itself as the owner of the asset nor it is ready to bear the liabilities of the leased asset while the procedure adopted by the Islamic banks proves that they consider themselves as the owner and bear the ownership liabilities.

## Diminishing Musharakah

The third common product of financing used in the Islamic banks is Diminishing Musharakah. This product is generally used for home financing, therefore, it is also known as' Home Musharakah'

The Procedure of this product consists of three stages.

1) In the first stage the Islamic bank and the client jointly buy a house in which usually the share of the Islamic bank is greater than the clients share. For example a house is jointly bought by the client and the bank in such a manner that the share of the bank is 80% in the property and the share of the client is 20%.

2) Banks share is divided into small units. For instance in the above example, the banks ownership of 80% share will be divided into 80 units and the client will gradually purchase these units, which will result in an increase in the client's ownership and decrease in the bank's ownership.

3) As the client wishes to use the bank's share, a separate rent agreement is executed between the bank and the client, through which the client uses the banks share and pays a certain rent. But as mentioned above, the client gradually purchases the bank's ownership share, the rent amount also gradually decreases until the client becomes the sole owner of the property.

Hence, there are three stages in this procedure.
1) A property bought jointly.
2) A partner (bank) rents out its share to the other (client).
3) Client gradually purchases the share of the bank.

All three stages mentioned above are of course permissible according to Shariah. The question which arises is that, either is it permissible to gather these three stages in a single agreement. The answer to this is that if two to more transactions are linked with each other in such a manner that they are conditional to each other, then it is not permissible.

المبسوط للسرخسی ۔ فتح القدیر ۔ المغنی لابن قدامہ۔

But if the transactions are not linked to each other in such a manner that if one of them is terminated the other transactions are terminated automatically then it is permissible. In Diminishing Musharakah none of the transactions are conditional to others, rather the client himself promises unilaterally that after partnership he will gradually buy the banks share.

It might be objected that the undertaking of the client to purchase the banks share is similar to make a condition in a sale. This is because, the bank from the first stage knows that the client will purchase the banks share, therefore it should be considered as conditional.

It may be replied that making a transaction conditional for the validity of the other transaction is different from making a unilateral undertaking. Conditional transactions mean that one will be considered complete when the other is fulfilled.

For example Khalid says to Ahmad that I will sell my car with the condition that you will rent your house to me. It means the sale of the car will be completed when Ahmad leases his house to Khalid. This is prohibited by Shariah as it consist of uncertainty, but if a transaction is not conditional and only undertaking is done then the transactions will not be considered conditional and a transaction will not be dependent on the other. Therefore in the product of house financing of the Islamic banks it cannot be said that the purchase of

the house jointly by the bank and the client is dependent on the promise of the client, rather the client in future fulfills his promise or not, the transaction of purchasing the house will take place. Although the client will be enforced to fulfill his promise, if he excuses do so. But because of his breach of promise the transaction executed will not be considered as void automatically. It can be said therefore, that the product of house financing in Islamic banks is not contrary to Shariah principles.

**Check & Balance System**

To check whether the transactions in the Islamic banks are in accordance with principles of Shariah, every Islamic bank or the Islamic branch of the conventional bank has a Shariah Advisor which is usually a prompt Shariah Scholar who not only advises the bank on their entire products but also supervises the operational procedures.

**Clarification**

Fair amount of details of the current modes of financing in the Islamic bank has been mentioned. We will now discuss some common issues in all the modes of financing.

**Some important Issues**

The common issues in the modes of financing in Islamic banks are as follows:

1) Before purchasing the asset like property or car, the bank takes a unilateral promise form the client that he will purchase or take on Ijarah after the bank purchases the asset. This promise is although unilateral and is only from the client but it is binding, therefore, do

the Shariah principles allow taking such a promise?

2) At the time of agreement the client undertake that in case of late payment it will give some amount in charity which will be consumed by the bank in charity purposes. Can an Islamic bank take such an undertaking?

3) The Islamic banks use the conventional benchmark to allocate their profit or rent. What is the ruling of Shariah in this regard?

**First Issue: Undertaking from the client**

The first issue is that after the inclination from the client the bank before purchasing the commodity from the market takes an undertaking from the client that he will afterwards purchase it on Murabaha basis or will take it on lease on Ijarah basis from the bank. The question arises whether it is permissible to take such promise, and if it is permissible, can it be called a binding promise according to Shariah principles?

As far as the undertaking is concerned there is no objection in this regard. It is similar to an example like Khalid has a bookshop, Zaid approaches him for a book which he does not have. Khalid informs Zaid that at the moment he does not have the required book but he can arrange the books for him after purchasing it from somewhere. Zaid shows his inclination but Khalid fears that Zaid may not purchase the book from him afterwards. Therefore he asks Zaid to undertake that he will purchase the book from Khalid. Of course Khalid can take such an undertaking as it does not coincide with any other principles of Shariah. Similarly the Islamic bank can also take an undertaking from the client.

As far as the question of a promise being binding or not is concerned, the answer is that there is a difference of opinion among the jurists, however Hanafi Jurists have allowed such a binding promise in cases of necessity ( Shami 4/135)

In our daily life the practical experience is that the promise is considered as binding. For example, hotel and caterers have arrangements with different suppliers to deliver different commodities on need. Many times caterers need to prepare food to deliver them for a wedding or other important ceremonies. Now at this time if the supplier excuses for supplying the commodities to the caterers, he will of course have to face severe inconvenience and loss. Likewise if someone arranges a ceremony he will be having arrangements with different suppliers of food, tent, lighting etc, but if at the eleventh hour they merely excuse themselves of providing the promised goods and separate themselves from the arrangements, the difficulty of the caterer and the person can be imagined. Therefore the promise should be declared as binding.

Likewise the Islamic banks have to purchase commodities of thousands & millions of rupees, therefore if the client afterwards refuses to fulfill his promise, they will have to face severe losses. Hence adopting the view of Hanafi jurists by declaring the promises binding is not against Shariah.

**Second issue: Collection of Sadqah**

The second issue which needs clarification is the amount of charity collected in case of delayed payments. A consideration may arise three questions, each of them with the answers are as follows:

1) The client of the Islamic banks undertake that incase of delay in

the payment they will donate a certain amount in the charity fund. No one can compel anyone as this is a personal matter (like in vow (nazar) no one can compel or force anyone to take a vow). While the client of the Islamic bank does not have the option of not making such an undertaking, rather he is compelled to make an undertaking if he wishes to do transactions with the Islamic banks. Is it permissible for the Islamic bank to take such an undertaking?

2) A condition is made that this charity will route through the bank. Is such a condition permissible?

3) If the client does not fulfill the promise the bank can approach the court to make the client fulfill his promise. Can such a promise be enforced through the court?

The answers of the above questions with the same sequence are as follows:

1) Imposing charity on a mistake is of two types:

a) The mistake is related in violating the right of Allah. (حقوق اللہ) For example one says that if I miss Fajr salat, I will give a certain amount of money in charity.

b) The mistake is related in violating the right of people. (حقوق العباد) In other words the mistake will cause loss to someone. For example a person in a journey undertakes to give certain charity in case he causes harm to his partner in the journey.

As far as the first type is concerned, it is purely the choice of the person to bind him and no one else can take such a promise from him. While in the other type (حقوق العباد) ,there are certain situations where

someone else can take the promise.

For example Zaid has a car in which he will travel with Bakr. Since Bakr enjoys driving he asks to drive the car. Zaid allows with the condition that Bakr will drive carefully and as a precaution he makes Bakr to undertake that if he drives carelessly he will pay certain amount to charity. Bakr accepts these conditions.

It is clear that it is permissible for Zaid to impose the first condition and likewise it is acceptable for him to make Bakr such promise, as object from both the promises is to protect him from the expected loss.

The second condition is binding in the sense if Bakr wants to drive Zaid's car than in case of carelessness he will have to pay a certain amount in charity. But the condition is not binding in the sense that Bakr has the option that he may not accept any condition and may not drive Zaid's car.

Islamic banks are a part of banking industry. They have a fair amount of funds from those depositors who have saved their lifetime savings. The bank uses these funds to finance its clients. If the bank does not use any effective method to avoid delay in payments the client usually will not pay on time for which the bank will have to face numerous financial problems. In fact there would be a risk of bankruptcy.

Hence, one can understand that it is necessary for an Islamic bank to take an effective stand while remaining within the bounds of the Shariah to protect itself and the depositors from this possible loss. One such method could be that the bank could get a promise from a client that he would pay on time together with an

undertaking that if he does not make his payment on time he would give a certain sum of money in charity.

Making this undertaking is necessary from this point of view that if a person wishes to transact with the Islamic bank he would have to make this promise. However, considering that one is not obliged to transact with the Islamic Bank, and that one has the option of trying to fulfill ones requirements from other permissible avenues making such a promise is not at all necessary (i.e. one is not forced to make this promise). Hence, just as it is correct for Zaid to get a promise out of Bakr that he would donate a certain sum of money in case he drives recklessly, it is also permissible for the Islamic bank to acquire a similar promise from its client.

2. The reason behind compelling the client to give these funds to charity by depositing them into the Banks charity account is to ensure that the client has indeed donated this money. The bank cannot include these funds as part of its income. Rather, it is obliged to spend the money in the avenues of charity. This condition is merely for the satisfaction of the bank that the client will pay the charity and the bank does not gain anything out of this. It is like a condition that further secures the transaction. And the inclusion of a condition that secures the transaction or a condition that confirms that the nature of the transaction is permissible.

According to the Hanafi School of jurists, this promise cannot be enforced by a court of law. Some of the Maliki jurists, however, allow this promise to be forceable through a court of law. As banks can only enforce their transactions through a court of law, there seems to be room for the Maliki opinion to be adopted in this situation. The Maliki school of thought is especially acceptable where commercial dealings are concerned. In this context, Hazrat Thanwi (R.A) has allowed the

adoption of the Maliki view for some commercial transactions in Imdad-ul-Fatawa.

**Third Issue: Using the interest rate as a benchmark**

The third issue pertains to the fact that presently Islamic Banks use the inter-bank interest rates as a benchmark to determine the profit that they offer to their depositor or rental that they charge on their financings. For example, in Pakistan KIBOR (Karachi Inter Bank Offered Rate) is used as a benchmark. It is argued that to do this is not permissible.

There is absolutely no doubt that making an interest rate a benchmark to determine permissible profits or rentals is indeed not liked. However, if an Islamic bank fulfills all the other conditions of a sale or Ijarah contract then the transaction cannot become invalid just because an interest rate is used to determine the profit.

This could be understood by the following example. Khalid requires Rs.100/-. He approaches Zaid and requests him for a loan. Zaid agrees to give Zaid this loan on a condition that he will repay him Rs.110/- at the end of the tenure. This transaction is clearly an interest based loan which is Haram and prohibited. Khalid leaves Zaid and goes to Ahmad. Ahmed asks Khalid the reason for taking the loan. Khalid tells Ahmad that he has got visitors and would like to purchase some fruit for them. Instead of giving him a loan, Ahmed purchase fruit of the value of Rs.100/- and after taking possession of them, sells them to Khalid for Rs.110/-. The transaction that Ahmed has concluded with Khalid is one of a sale and purchase agreement in which he first purchased fruit for Rs.100/- from the market, took possession of them and thereafter sold them to Khalid. If one has to analyze both the situations above then indeed there is a similarity between Ahmad and Zaid's transactions from this point of view that Ahmad has earned the

same amount of profit by selling the fruit that Zaid was demanding in the form of interest. Despite this resemblance, no person who is acquainted with the principles of Shariah can ever say that the profit that Ahmed has earned is Haram and impure because he has earned (in the form of interest) by giving a loan. Rather, it will be said that since Ahmad has upheld all the principles of Shariah and concluded a valid sale then just because of this outer resemblance one cannot deem, his sale impermissible. Hence, if Islamic banks uphold the principles of Shariah in their Murabaha, Ijarah and Diminishing Mushrakah transactions then just because of their using an interest based benchmark to determine their profit or rental their transaction will not be impermissible.

**We should also search for an Alternative**

However, an interest rate benchmark to determine permissible profits make a Shariah compliant transaction resemble an interest based transaction. Therefore, it would be preferable that Islamic banks exert their efforts to strive and avoid even such apparent resemblance. However, we should also analyze why Islamic banks currently use interest based benchmarks in determining their profits and what difficulties do they face in searching for an alternative.

The history behind the inter bank interest rate is this that generally different banks do not run under the same circumstance. Some banks have more money whereas others have less than what they require for financing. The banks which require funds thus acquire loans from those banks which have extra funds. The banks which give loan give them on a specific rate of interest. This rate called the Inter Bank Offered Rate. In short, it is referred to as IBOR. In Pakistan, the interest rate that prevails between banks in Karachi is usually used as a benchmark and is referred to as KIBOR. (Karachi Inter Bank Offered Rate).

If Islamic Banks in Pakistan desire to use an Islamic benchmark in place of KIBOR, then it is clear that this would require the existence of a big Islamic banking market. Alhamdullilah, this market is slowly progressing in Pakistan. Some contemporary Ulama have suggested that Islamic Banks should form transferable instruments that are backed by physical assets such as property or assets that have been leased out. The Islamic Banks who have given out assets on lease should formulate shares of these assets. Therefore, those Islamic Banks that have surplus funds can purchase these share of the basis of net asset value. (The net asset value of these shares could be determined at different intervals.) Similarly those Islamic Banks that have more shares than they require can sell their shares. In this manner, an Islamic Inter Bank market would come into existence. Islamic Banks could then use the net asset value of these shares as a benchmark to determine their profit in the different forms of financing that they provide. In this manner a Shariah compliant alternative to KIBOR will be formed.

**The Difference between Islamic Banks and Conventional Banks on the Liability Side**

The previous discussions all relate to that side of the balance sheet which is generally referred to as the asset side. Now we shall briefly analyze the “liability” side of the balance sheet in which the Islamic Banks accept funds from various depositors and make them partner in their profits. The difference between the liability products of a conventional and Islamic Bank can be clearly understood if certain common arguments are explicitly explained.

**The Current account of Conventional Banks and Islamic Banks are identical to each other**

The money that a conventional bank accepts as deposits is

regarded as a loan in the Shariah regardless of which account it accepts the deposits for. This is because the conventional banks guarantees that every account holder will definitely receive the full amount of money that he has deposited and any capital whose return is guaranteed is regarded as a loan in Shariah. Now, if the account is a current account then the conventional bank will not give its depositors any extra money above their deposits. Rather, they are only responsible to return the amount deposited. This transaction of the conventional bank does not go against any principle of the Shariah. The current account of an Islamic bank also transacts in exactly the same manner. However, if a depositor wishes to place some funds in a current account then he should deposit his funds with an Islamic bank rather than a conventional bank so that his loan to the bank is used in Shariah compliant forms of financing rather than in financing on the basis of interest based loans.

**The difference in the other accounts**

Besides the current account, the other accounts such as saving account or fixed deposits etc, the conventional bank takes an interest based loan from its depositors.

It is as though a Conventional Bank takes capital from its depositors and gives them this assurance that their capital is safe and that after specified period they shall receive their deposits along with an extra mark-up.

How will they receive this mark-up? Where will these funds of the depositors be spent? How much will the bank earn from these funds? What will be the share of the depositors form this income? A veil is placed on this question. Whether the bank earns 100% profit from the depositors' funds or does not earn anything, the bank is bound

to give its clients the stipulated rate of interest. Hence, it is as though there is no connection between the relationship that the depositor has with the bank and that which the bank has with the clients that acquire finance from it.

Contrary to this, the funds that an Islamic bank accepts in account that generate profits are accepted on the basis of Mudharaba or Musharakah. Also, these funds are held as a trust by the Islamic Bank. In other words, if these funds or a part of them are destroyed due to circumstances not under the control of the bank, then the bank will not be responsible to return these funds.

Secondly, after accepting funds from its depositors, an Islamic Bank does not put a veil on these funds. Rather, they make their depositors partners in their investment projects in which the depositors are the Rabbul Maal (investor of capital) or sleeping partners and the Islamic bank is the Mudharib or working partner. The bank gives a proportional share of the profit that it earns from it's different forms of financing such as Ijarah, Murabaha and Musharakah etc. to its depositors. This profit sharing ratio is pre determined. For example, it is agreed that whatever profit the bank earns will be distributed between the bank and the depositors on a fifty fifty basis.

Since, the bank makes the depositors partners of proportionate shares in the profit it earns; a chain is formed amongst the depositors, bank and clients who acquire finance. The result of this chain is that the profit that the bank earns from its clients directly impacts the profit that the depositors receive. Hence, if the Islamic bank provides financing at a higher rate, their depositors will receive a larger profit whereas if they offer financing at a lower rate, their depositors will receive a smaller profit and this is in accordance with the principle of the Shariah.

**An Islamic bank cannot fix the profit in advance**

Its is important to keep in mind that when accepting a deposit, an Islamic bank cannot guarantee its return to the depositors, neither can the Islamic bank tell the depositors with certainty that it will give a specific amount of profit. The fixing of a profit in relation to the capital invested by the depositors is not at all permissible in Shariah. For example, if an Islamic bank tells its depositors that it will give them a profit of 10% on the amount that they have invested, then such a fixture of the profit renders the transactions of Shirkat and Mudharabah void. However, at the end of a particular term, when the bank distributes the proportionate shares of the actual profits earned to its depositors then it is permissible to calculate the profit received in relation to the capital invested and to announce the same.

This could be understood by the following example. The bank (A) accepts a deposit of Rs.100/- from a depositor (B) and earns a profit of Rs.20/- on this investment. The bank keeps 50% of the profit earned and gives the depositor 50%. In this manner, the depositor receives Rs.10/- in the form of profit on his investment. This Rs.10/- is in reality 50% of the profit earned. However, if it is calculated in relation to the capital invested by the depositor then it will be 10% of the capital invested.

Hence, if an Islamic bank announces that it has given its depositors a profit of 10% on their investment, it is allowed. However, at the outset a specific rate cannot be fixed with certainty. This is because, firstly, the transaction of Shirkat and Mudharabah become void and impermissible. Secondly, the Islamic bank does not know in advance how much profit it will earn from this capital. This explains that if an Islamic bank, after distributing profits, announces that this year it has given its depositors 10% profit then this does not go against any principle of the Shariah.

## It is not correct to declare an individuals fault, a fault of the system

After studying the previous pages this point has come across very clearly that the method adopted by the present Islamic bank is not against the principles of Islam. Therefore, it is permissible to deposit funds with Islamic banks and also avail financing facilities offered by them. However, at this point it is also important to understand that although all Islamic banks have a Shariah Advisor to check their transactions, it is not necessary that all the transactions of all the Islamic banks are in reality being carried out in the same manner in which they have been structured. In fact, there is a possibility that some transactions or the other taking place in a branch of some Islamic bank somewhere is not conformity with the Shariah. Whether such a fault is committed due to ignorance of the client of the bank or the employee or the laws of Shariah were ignored due to the greed of earning a higher profit, or for whatever reason, the path of justice is that this fault be considered a fault of the individual concerned. Declaring this a fault of the entire system is not at all justified.

The above argument can be clearly explained with the help of an example. There is particular method for doing Wudhu as outlined in Islam. However, if one individual who out of ignorance or haste perform his Wudhu in such a manner that he does not perform the Masah of the head, it would not mean that the method of Wudhu which Islam has taught does not include the Masah of the head. Rather, every intelligent person would agree that this was the mistake of this individual.

## The Method of acquiring the correct facts

Similarly it is also a reality that presently there is a shortage of individuals who have a reasonable amount of knowledge regarding

Islamic banking. Therefore, there are various institution that are busy conducting training sessions in Islamic banking. However, most of the individuals who undergo this training are those who have worked in conventional banks for many years and it is very obvious that they will not be able to acquire expertise in the depths of Islamic banking from a single course. It is for this reason that some times the employees of Islamic banks are unable to explain the different methods of Islamic financing properly. This becomes more evident when they are required to speak with someone who is acquainted with the law of the Shariah. They are unable to give the correct explanation, from which this conclusion is reached that the present form of Islamic banking is not in compliance with the principles of the Shariah. This method is not correct. One who is searching for the truth should not suffice on meeting with the employees of an Islamic bank. Rather, the best method would be that such a person acquires clarification on the transactions from the Shariah Advisor of that bank or at least he should seek guidance from some reputable and competent scholars who have more knowledge in this field. In this manner, one would gain assistance in understanding Islamic banking in a better way InshaAllah.

**Some aspects that require attention**

Now we shall point out some of those aspects of Islamic banks which require either improvement or change.

1. As mentioned in the beginning of this booklet that if transactions such as Murabaha and Ijarah are concluded according to the principles of Shariah then transacting in these manners are permissible. However, these are not the preferred methods of financing. Therefore, instead of sufficing on these forms of financing, Islamic banks should keep on making a concerted effort to finance client on the principles of

Musharakah and Mudharabah. Presently this effort is not being made to a satisfactory degree.

2. Although the employees of Islamic banks are acquiring training from various institutes there is still a lot of work required in this regard. Besides acquiring training from external institutes there is also a great need to make this the subject of our discussions within the banks. One method in which this can be done is that one person in every branch who understands the transactions well can share his knowledge with the fellow staff. Some time should be allocated for discussing theses aspects and wherever required the guidance of the Shariah Advisor can be sought.

3. Just as it its necessary for the staff of an Islamic bank to acquire the knowledge of the various transactions, it is also necessary for the clients to have a basic understanding of Islamic banking concepts. Currently, the clients of Islamic banks have insufficient knowledge of transactions which can result in transaction becoming void due to the mistake of the client. Hence, it is necessary to formulate methods for training the clients and providing them with complete understanding of Islamic concepts.

4. One important aspect regarding which many people have complained is that the dress code and outer appearance of the staff working in Islamic banks is just like the dress code and outer appearance of those working for conventional banks. Similarly like in conventional banks, females working for Islamic banks are without adequate pardah. These two aspects require critical attention and Islamic banks should work hard to take a positive step in this regard as quickly as possible. If the depositors and clients of Islamic banks put pressure on the banks in a reasonable manner it would have very beneficial effects in this regard. Moreover the bank management should revise

its policy itself on this issue. Some Islamic banks have come forward in this case that they have made the scarf compulsory for the female staff and the male staff have the option of wearing shalwar qameez. This is a good step and other Islamic banks should also take such similar steps.

May Allah guide us to make our inner and
outer appearance accordance with the Shariah.
(Ameen)

وصلی اللّٰہ تعالیٰ علی النبی الکریم وعلیٰ آلہ وصحبہ
اَجمَعین